approach would penalize cable systems that engage in long-term investment; it would provide strong incentives to operators of highly-depreciated systems to abandon serviceable plant and replace it with new, undepreciated plant,[90] and would produce disincentives for investment in infrastructure.[91] Some operators also argue that use of original cost produces rates that are substantially lower than competitive levels.[92]

48. Other operators argue that acquired systems often lack records for ascertaining original cost, or that it is simply impractical to use such an approach.[93] Some argue that use of original cost distorts the ratebase because it fails to include inflation, or operating losses for years prior to rate regulation.[94] Others argue that plant may be fully depreciated, leaving original cost minimal; in that case, they assert, using original cost would not provide an accurate or fair assessment of assets.[95] Several parties assert that courts have held that the additional amount of value over book must be considered in setting rates, and that to fail to do so would be unfair,

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Summit Comments at 7; Viacom Comments at 16; Time Warner Comments at 29; Cablevision Industries Reply at 5.

[90] Avenue TV Comments at 2 (stating that the use of original cost for plant valuation would force it to buy unneeded new plant, using high-cost loans, to replace heavily-depreciated but serviceable plant. When a more reasonable plant value is assigned, Avenue TV states, it can upgrade and replace plant as needed from within its operating budget. Thus reliance on original cost produces inefficiency and higher rates).

[91] TMC Comments at 12 (original cost approach causes ratebase to be minimal, providing little if any capital for infrastructure development).

[92] See, e.g., Cablevision Industries Comments at 29-30.

[93] See, e.g., COA Comments at 51-52 and White Paper Attachment at 36-38; Continental Comments at 41-43 (using original cost would require such steps as restating gross assets and restating depreciation reserves to match the new value of assets); Georgia Cable Comments at 18-19.

[94] See NCTA Comments at 11; Continental Comments at 26.

[95] See, e.g., Time Warner Comments at 29; TMC Comments at 12.

confiscatory, and contrary to public policy.[96]

c. Replacement Cost and Reproduction Cost

49. In the Notice we defined replacement cost valuation as valuing plant at the cost of building a new "state of the art" facility.[97] We defined reproduction cost as the present cost to construct the plant that is in service.[98]

50. TMC recommends use of replacement cost methodology because, TMC argues, it allows plant upgrades and takes advantage of cost efficiencies that result from this development to keep rates reasonable.[99] Other parties, however, oppose the use of replacement cost as burdensome and unreliable.[100]

51. Several parties argue in favor of reproduction cost, depreciated.[101] Others oppose this approach, arguing that determining the cost of reproducing an old system makes no sense in determining the value of the capital committed to the

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[96] See, e.g., Continental Comments at 26-27 (citing McCardle v. Indianapolis Water Co., 272 U.S. 400, 414 (1926)); NCTA Comments at 7-8. Viacom states that original cost should not be applied to systems that were acquired at arm's length during the period of deregulation between the Cable Act of 1984 and the Cable Act of 1992 because there would be no excess acquisition costs during this period. Viacom Comments at 20-21.

[97] Notice at n.37.

[98] Id. at n.38.

[99] TMC Comments at 12. TMC recommends that the Commission, to ensure the continuity of replacement costs in the industry, monitor the reasonableness of costs assigned by operators in light of the technological features of each system.

[100] See, e.g., COA Comments at 27; Continental Comments at 27; ETC Comments at 3 (claiming that the replacement cost approach is speculative and results in allowing a return on assumed or hypothetical standards rather than actual investments); Bell Atlantic Comments, Appendix at 17 (it is burdensome, lacks objectivity, and has been largely abandoned by other regulatory commissions).

[101] See, e.g., Small Systems Comments at 10, n.13.

enterprise.[102]

d. Other Approaches

52. Several parties advocate a "fair value" approach to valuation of plant in service.[103] Fair value is the current market value of the property placed in service, and may be determined in several ways, including market value and replacement cost. Several parties also advocate other approaches, including an operating ratio analysis to test the reasonableness of rates;[104] ratebase equal to the invested capital on the books with a transition to original cost over a ten-year period;[105] or a current value (trended original cost) approach.[106]

e. Discussion

53. We conclude that an original cost approach is most likely to produce fair and reliable valuations of plant in

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[102] COA Comments at 66-67; Continental Comments at 28 (such calculations are inherently subject to inaccurate predictions, and would fail to reflect the capital which must be committed to a new build, sustaining start-up losses and deferred returns through the initial years of development).

[103] See, e.g., Summit Comments at 7 (fair value of all assets belong in the ratebase and should be depreciated and amortized over their useful lives); Bell South Comments at 16 (allow the assets to be recorded at fair market value, in accordance with Generally Accepted Accounting Principles (GAAP), with cost in excess of fair market value of the assets recorded as goodwill); COA Comments at 52 (the Commission should use fair value at the time the operator's property is first devoted to public use); Comcast Comments at 29 (industries initially subjected to regulation typically received a return based on either system replacement costs or fair market value). (See also Comcast's "Z factor" proposal, discussed in III.A.2.e., infra.)

[104] COA Reply at 32-33, n.65.

[105] Comcast Reply, Appendix at 26.

[106] Arthur Andersen Comments at 25-32. The Commission would use a transitional approach to establish a current value for the property, plant and equipment of the cable operators as of the date the Cable Act of 1992 was enacted, which would be the fair market value of the original trended cost of the system. The commenter describes how this approach would operate, and asserts that this methodology would balance our stated concerns.

service, and allows us the best opportunity to balance operators' reasonable recovery of costs with consumers' payment of rates that reflect only costs reasonably incurred in providing regulated service. We find that none of the other valuation approaches provides the same reliability and fairness as this approach.[107]

54. For purposes of our cable cost-of-service rules, we define original cost as the actual money cost (or the money value of any consideration other than money) of property at the time it was first used to provide cable service. Costs for both constructed and purchased systems will be subject to scrutiny by the appropriate regulatory authority to determine whether the investment was prudent and the plant is used and useful.[108]

55. Original cost is the normal, now traditional method used for public utility valuation, and is the method this Commission has long used for telephone companies. By relying on actual expenditures rather than speculative or contentious valuation methods, original cost is far more likely to achieve the desired result: reasonable rates for customers, a fair opportunity for a reasonable return for operators, and reduced administrative burdens.[109] The practical benefits of original cost valuation in general are that it is less administratively burdensome on all involved, and well understood.

56. Thus, unlike the other valuation approaches, original cost does not require estimates of current values that may be difficult or expensive to determine, and that are in any event likely to be largely matters of opinion. Unlike market-based valuation methods, it does not present the problem of circularity, where the valuation method chosen itself affects the

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[107] We discuss infra the shortcomings of other approaches.

[108] The regulator may examine whether the construction costs were reasonable, whether plant is operating at a reasonable level of capacity, and whether costs are properly apportioned between regulated and nonregulated activities. In this respect we require operators subject to regulation under Section 623 of the Communications Act, 47 U.S.C. § 543, to keep, maintain and protect records subject to regulations adopted in this Report and Order for a period of not less than 5 years. We have authority to take this action under Sections 4(i) and 623 of the Communications Act, 47 U.S.C. §§ 4(i) and 543.

[109] For a history of the development of and debate over valuation methods in public utility ratemaking, see I. Kahn, The Economics of Regulation 40-41 (1988).

value that the market is likely to place on the system. It is also not constantly changing as the economy, technology, and customer needs change. Original cost valuation is also recognized and defined, and used for financial accounting purposes, as part of Generally Accepted Accounting Principles (GAAP). Indeed, it has been this Commission's policy in recent years to bring its regulatory accounting into conformance with GAAP as far as possible.[110] Use of original cost for cable systems will help implement this policy and minimize regulatory accounting burdens.

57. These practical benefits are particularly significant for cable system regulation, where Congress has expressly directed us to reduce administrative burdens. Use of original cost should reduce administrative burdens because it does not require appraisals or other methods of assessing value at a later date, and it is the most familiar method for regulatory cost of service studies. Original costs also are likely to be far less contentious because they can generally be objectively verified by reference to actual construction records and, for many operators, are readily available. On a going forward basis, operators should easily be able to keep track of these costs. To the extent that original costs may not be readily available to operators who have acquired systems, estimated original costs may be used. We have also modified the original cost approach, as we discuss below, to permit the use of book value if it approximates original cost.

58. We recognize that original cost valuation, like any valuation methodology, has theoretical limitations -- in this case, that it is a backward-looking approach to costs. However, these limitations do not prevent it from being a practical, workable foundation for establishing value of tangible plant in service.[111] To the extent that use of original cost for computing the ratebase affects the risks that investors may assign to cable systems, we can take account of such risks in determining a

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[110] See, e.g., Revision of Uniform System of Accounts, Classes A, B, and C Telephone Companies, CC Docket No. 78-196, Report and Order, 51 Fed. Reg. 43498, Dec. 2, 1986. Continuing this Commission's reliance on GAAP, we direct that GAAP shall generally apply in our regulation of cable rates, unless specifically noted otherwise.

[111] Parties asserting that the Commission must allow additional amounts are incorrect. Original cost has been explicitly accepted as a reasonable method of ratebase valuation, provided the end result of the ratemaking process cannot be said to be unjust and unreasonable. Hope, 320 U.S. 591.

reasonable rate of return that will allow the system to operate successfully and attract the necessary capital. Thus, in setting the rate of return here we have adopted a rate toward the high end of the zone of reasonable returns, as a cautious approach to assure continued incentives for future investment.

59. The original cost approach is also consistent with the objectives of the Cable Act of 1992. The Act directs this Commission to consider various factors in establishing criteria for evaluating the reasonableness of rates, including reducing administrative burdens, and taking into account direct costs, joint and common costs, advertising and other revenues, franchise fees and taxes, franchise requirements, and a reasonable profit.[112] It does not direct us to include other acquistion costs. The adoption of the original cost valuation method allows us to meet express statutory concerns; i.e., original cost valuation excludes costs that would not have arisen in a competitive environment, and a primary factor in our evaluation of cost-of-service showings is the rates for cable systems subject to effective competition.[113]

60. While it might be possible to develop a different valuation approach, including one of the various approaches suggested by cable operators, we perceive no reason to believe that any one of those methods would better carry out the purposes of the Cable Act. Approaches based on market value at the time of acquisition are likely to include expectations of supra-competitive profits that would be difficult to disentangle from other aspects of market valuation, such as the expectations at the time of the growth and profitability of unregulated services. We also believe that the commenters favoring market valuation methods understate the practical difficulty of applying sale prices of some systems or trends in stock prices to setting a market price for other systems. Certainly these methods are more complex than use of original cost, even if they could be developed into a reliable valuation method that excludes supra-competitive earnings and non-regulated activities. To the extent that acquisitions occurred at different times in the past, those expectations are also likely to have varied, and use of the full acquisition price is thus likely to produce uneven and unreliable valuations. Moreover, the full acquisition price might well represent an imprudently high purchase price rather than a fair valuation for customers, even if it was arrived at on an arm's length basis at the time.

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[112] Communications Act, § 623(b)(2), 47 U.S.C. § 543(b)(2).

[113] Id. at § 623(b)(1)(C)(i) and (c)(2)(B).

61. An attempt to apply a market value test as of the date of the adoption of the Cable Act in 1992 or at some later date presents similar problems of circularity, assessment of investor expectations, and allocations to regulated services. In practice, these issues have proven very difficult to solve in developing workable public utility ratemaking mechanisms. What has proved workable, even if far from simple, has been use of original cost for valuation, and assessment of market requirements for return in the setting of an allowable rate of return based upon that valuation method. The Cable Act of 1992 does not state or imply that the Commission must take into account the market value of cable systems in evaluating reasonable rates, and we conclude that use of market value in setting the value of plant in the ratebase would be less workable, and would not result in more reasonable rates, than use of original cost in implementing the 1992 Cable Act of 1992.

62. Similarly, we reject the replacement cost, reproduction cost and fair value approaches as unwieldy, difficult to apply consistently, and likely to produce ratebase values that would not generate reasonable rates. Estimating the cost of replacing a system or reproducing it would likely prove a contentious exercise in competing opinions concerning, for example, current construction costs, best practices, and choices of technology. Attempts to implement a fair value approach have also historically proved unworkable.

63. We also are unpersuaded that the other methods proposed are preferable to original cost in carrying out the purposes of the Cable Act of 1992. COA's suggestion in its reply comments that an operating ratio analysis could be adopted to test rates seeks to draw an analogy to cases such as transit utilities where the ratebase is very small.[114] It is improbable, however, that the cable industry, with its heavy capital investment in facilities, is analogous to situations where operating ratio approaches have been adopted.[115] This and other approaches, such as Comcast's "Z factor" proposal, Arthur Andersen's trended original cost proposal, and BellSouth's proposal for amortization of goodwill, appear primarily to be approaches seeking to include in the ratebase some portion of excess acquisition costs. We discuss these approaches and the extent to which acquisition costs may appropriately be included in the ratebase in a later

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[114] COA Reply at 32-33.

[115] It is also not clear what expenses COA would include in operating expenses or what ratio it would consider appropriate. See COA Reply at 32-34.

section of this decision.[116]

64. Commenters arguing that original cost is often simply unascertainable were numerous and insistent, and we believe that there may be some validity in this concern in some cases for purchased systems. We note that telephone regulation provides for use of an estimated original cost when actual original cost is not available.[117] Because this approach creates the need for individual scrutiny not only of the estimated original cost but also of underlying 'particulars,' it is not our preferred alternative to original cost for cable services regulation. However, in the event that an operator does not possess adequate records of original cost, we will permit an operator to estimate original cost. The operator will be required to show the basis for the estimate with supporting documentation. In addition, we will permit valuation of tangible plant in service at the book value recorded by the operator at the time of acquisition, if the operator can demonstrate that book value approximates original cost.[118]

65. We believe that this approach to valuation strikes a fair balance between the interests of ratepayers and investors, and that it will produce reasonable rates for subscribers while allowing operators to recover costs that they have prudently incurred for plant that is used and useful in the provision of regulated cable service. Under this approach, cable operators will be able to attract capital, and will have an opportunity to earn reasonable earnings. The original cost approach will also protect consumers from paying for costs inappropriately incurred by operators, or for monopoly rents.[119] Finally, it will help in

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[116] See infra part III.A.3.

[117] Part 32 of the Commission's rules, USOA for telephone companies, defines original cost as "the amount of money paid (or current money value of any consideration other than money exchanged) for the property (together with preliminary expense incurred in connection with the acquisition)." 47 C.F.R. § 32.2000(b)(2)(i). This is the definition we used in the Notice, and that we adopt here. The rule then states: "When the actual original cost cannot be determined and estimates are used, the company shall be prepared to furnish the Commission with the particulars of such estimates." 47 C.F.R. § 32.2000(b)(2)(ii).

[118] All cost showings for acquired systems must include the book value of tangible plant in service as recorded at the time of acquisition. See Cost of Service Form 1220.

[119] See Cable Act of 1992, § 2(b)(4).

reducing administrative burdens on both cable operators and regulatory authorities in the administration of our rate regulations by permitting reliance on estimated original cost or book value in some cases.[120]

66. The original cost valuation approach for tangible plant in service is also consistent with the Act because it will allow operators to develop rates that approximate the rates that would have developed in a competitive market, and will thus protect subscribers from paying inappropriate costs and unreasonable charges[121] that reflect operators' expectations of noncompetitive earnings or earnings from non-regulated activities.[122] This approach also assures operators' ability to respond to competitive forces by means of facility and service requirements, because it allows them to recover costs prudently invested in plant that is used and useful in the provision of regulated cable service. We also believe that by instituting an original cost approach to initial determination of ratebase, we are setting the groundwork for a level playing field for the telephone companies and cable companies, because our telephone company valuations are also based on original costs.

67. As several parties have noted, Congress identified the goal of ensuring that cable operators continue, where economically justified, to expand their telecommunications infrastructure.[123] The Commission agrees that cable operators can, and should, contribute to the continued development of an advanced telecommunications infrastructure. Contrary to some commenters' suggestions, we believe the approach we adopt today

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[120] See Communications Act, § 623(b)(2)(A).

[121] See Utah Comments at 14; Michigan Comments at 14.

[122] See Cable Act of 1992, § 2(b)(4).

[123] Cable Act of 1992, § 2(b)(3); see also Telephone Company-Cable Television Cross-Ownership Rules, 47 C.F.R. §§ 63.54-63.58, Notice of Inquiry, 2 FCC Rcd 5092 (1987), Further Notice of Inquiry and Notice of Proposed Rulemaking, 3 FCC Rcd 5849 (1988), Further Notice of Proposed Rulemaking, First Report and Order and Second Further Notice of Inquiry, 7 FCC Rcd 300 (1991), recon. granted, 7 FCC Rcd 5069, appeal pending sub. nom. National Cable Television Assoc., Inc. v. FCC, No. 91-1649 (D.C. Cir. filed Dec. 26, 1991), Second Report and Order, Recommendation to Congress and Second Further Notice of Proposed Rulemaking, 7 FCC Rcd 5781 (1992), petitions for recon. pending, appeal pending sub. nom. Manakato Citizens Telephone Co. v. FCC, No. 92-1404 (D.C. Cir. filed Sept. 9, 1992).

allows operators to participate in the development and establishment of a modern telecommunications infrastructure, by assigning a reasonable value to tangible plant in service and permitting operators to recover that value in rates for regulated cable services.

3. Additions to Ratebase

a. Accumulated Start-Up Losses

i. Notice

68. In the Notice we remarked that some operators may have expensed, rather than capitalized, some expenditures which have resulted in the creation of assets with future economic value.[124] We noted that the application of certain depreciation practices may have resulted in a general undervaluation of property, plant, and equipment on the books of cable operators as the industry comes under regulation, and that financial losses in the industry may be due in some part to write-offs of various organizational and development costs, and to use of accelerated depreciation practices. We sought comment on the appropriate treatment of accumulated losses, noting that it might be reasonable to view such losses as capital invested with an expectation of recovery in future periods as the industry reaches maturity. We asked whether these losses should be amortized over some future period, and whether a return should be allowed on such unrecovered amounts until they are fully recovered.

ii. Comments

69. In response, several parties contend that cable operators incur more substantial early losses than traditional utilities.[125] Small Systems argues that start-up losses, deferred

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[124] Notice at n.44.

[125] See, e.g., COA Comments at 50 (cable operators have routinely expensed start-up costs resulting in operating losses in the early years of operation), White Paper Attachment at 24; Cablevision Systems Comments at 6-9, 25 (these losses were incurred in an unregulated environment with the expectation that they would be recovered); California Cable Comments at 34. A regulated firm, COA asserts, would have capitalized these start-up losses and recovered them in later years. The fact that cable's accounting has not yet created that regulatory asset does not mean that these amounts do not produce economic value even though they may be reflected only in goodwill or other intangible assets on the books of account. COA Comments at 50.

system development costs, and accumulated losses which operators invested to make their cable systems viable commercial operations should be recoverable.[126] Others add that these losses should be both capitalized (to include a return on investment), and amortized (to allow recovery of expense).[127] Many parties propose recovery methodologies and periods.[128]

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[126] Small Systems Comments at 12-14 (defining start-up expenses as the "excess of expenditures required to build and operate the fixed plant over revenues received from the initially small subscriber base.") Small Systems notes that courts have recognized that the expense of financing construction and operating a facility during the early unprofitable years of operation is a legitimate expense which must be borne by the ratepayer. Tennessee Gas Pipeline v. FERC, 606 F.2d 1094 (D.C. Cir. 1979), cert. denied, 445 U.S. 920 (1980); McCardle v. Indianapolis Water Co., 272 U.S. 400 (1926). To allow these costs in the ratebase, Small Systems argues, does not constitute a requirement that future ratepayers provide retroactive compensation for some deficiency in the way the cable system is operated, but is merely fair recovery of the inevitable early expenses that permit the later subscribers to receive cable service. Small System Comments at 16. See also Arthur Andersen Reply at 11 (suggesting that this could be defined as the excess of total costs incurred over revenues during the start-up phase of the cable system, or that the Commission could establish benchmark amounts for average per customer acquisition costs); Cablevision Industries Comments at 25; Cablevision Systems Comments at 31-32; California Cable Comments at 33-34; COA Comments at 50, 54-55, 57-59; Continental Comments at 44; Media General Comments at 8; TCI Comments at 4; Small Cities Reply at 18-19.

[127] Cablevision Industries Comments at 24; see also Georgia Cable Comments at 25. COA asserts that accumulated losses should be allowed to be amortized over a ten-year period, with all unrecovered amounts (i.e., those initial losses that will never be compensated) receiving a fair return by their inclusion in the ratebase. COA Comments at 54-58 (noting that the Commission has allowed telcos to include deferred start-up costs in the ratebase). See also Medium Operators Reply, Appendix at 12.

[128] California Cable Comments at 40 (compare start-up costs to the treatment of construction work in progress or allow deferred cost recovery); Continental Comments at 48-49; Media General Comments at 8-11 (amortization period should be decided on an individual basis); Time Warner Comments at 21; Summit Comments at 5 (arguing that not allowing recovery of accumulated losses would have negative effects on small operators' ability to

iii. Discussion

70. We conclude that some accumulated start-up losses, to the extent that they reflect operating losses in the early years of the system, should be included in the ratebase. These losses could be considered to meet the used and useful standard in that it is frequently necessary for businesses during a start-up phase to sustain a period of losses prior to profitability. As such, the losses benefit customers because it is necessary for the operator to incur them in order to bring future service to subscribers.[129] We are also concerned, however, that current customers not be burdened with excessive or unreasonable costs from previous periods of operation, that cable operators' recovery of these costs not be unlimited in time, especially after the losses have been recouped, and that subscribers not pay for losses incurred in expectation of recovery of future supra-competitive profits.

71. Financial Accounting Statements Board Standard No. 51 ("FASB 51")[130] suggests that a two-year period is a reasonable and

raise future financing, and proposing a fifteen-year amortization period from the date of the first rate hearing). Medium Operators states that the amount of past losses to be recovered should be reduced by an estimate of the tax benefit received, but that such reduction should be allowed only for entities that are allowed to recover an allowance for taxes under the cost of service rules. Medium Operators Reply, Appendix at 25.

[129] The Commission has considered a similar issue before; we denied a Comsat request to establish a "return deficiencies" account that would have compensated Comsat for deficient returns during the early years of operation. Communications Satellite Corporation, 56 F.C.C.2d 1101, 1129-32 (1976). We recognize that the proposal we rejected in 1976 bears some resemblance to the startup cost allowance we are adopting for the cable industry. The startup allowance we are adopting here is, however, far more limited than the Comsat proposal, and the decision to deny Comsat's request was based in part upon a finding that other accounting and ratemaking decisions that were unique to Comsat adequately compensated Comsat for its startup costs. Therefore, we believe our decision to adopt a startup allowance here is not a departure from relevant Commission precedent.

[130] Statement of Financial Accounting Standards No. 51, Financial Reporting by Cable Television Companies ("FASB 51") establishes standards of financial accounting and reporting for costs, expenses, and revenues applicable to the construction and operation of cable television systems. Under these standards,

representative startup time for cable systems. We believe, based on the record, that this period would permit recovery of losses necessary for start-up of a cable system, and that a subscriber base is likely to be well established by the end of the second year of operation. We therefore allow recovery in the ratebase of accumulated start-up losses that are equal to the lesser of the first two years of operating costs or accumulated losses incurred until the system reaches the end of its prematurity stage as defined by FASB 51.[131]

72. These accumulated losses may be included in the ratebase, and the operator may earn on them the reasonable rate of return that we define below.[132] However, we do not believe that these accumulated losses should be included in the ratebase indefinitely. Instead, we will require that they be amortized[133]

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when a cable system is partially under construction and partially in service (the prematurity period), costs incurred that relate to both current and future operations shall be partially capitalized and partially expensed. Under FASB 51, the prematurity phase of a cable television system is presumptively no longer than two years.

[131] We believe that losses incurred during this period are most directly linked to the creation of the system that is currently providing services to subscribers. Cable operators are, of course, free to make a showing that demonstrates the appropriateness of a practical adjustment to this rule in light of their particular circumstances. Operators are also free to present evidence to rebut disallowance of other accumulated losses. In challenging this or any presumptive disallowance, the operator must present detailed evidence demonstrating that the cost has produced a tangible benefit for subscribers that would not have existed but for the cost; and that the relevant plant is used and useful in the provision of regulated cable service, and represents a prudent investment. The operator may present evidence that allowance is necessary for compensatory rates. In making its determination, the regulatory authority should take into account the effect that allowance of this cost or costs will have on the operator's rates in comparison to rates that would have developed in a competitive environment, and whether allowance of these costs will produce reasonable rates.

[132] <u>See</u> part IV., <u>infra</u>.

[133] Amortization means the systematic recovery, through ratable charges to expense, of the cost of assets.

over a reasonable period.[134]
We determine presumptively that this amortization period should not be longer than fifteen years.[135] This amortization period should provide flexibility for operators, without burdening subscribers with unreasonable rates.

73. We conclude that other losses should be presumptively excluded from the ratebase: these include continuing operating losses after the system reaches maturity,[136] and accumulated losses associated with amortization of disallowed goodwill or interest expense associated with disallowed goodwill.[137] We believe that this treatment is appropriate because these costs presumably benefited past subscribers, or were incurred in the expectation of monopoly profits or profits from nonregulated activities, and thus should not be borne by current and future subscribers.[138]

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[134] The operator must submit detailed evidence of the effect the amortization period has on rates in comparison to competitive rates of similar systems. The regulatory authority may after careful scrutiny revisit the amortization period if it will produce unreasonable rates. Unless otherwise provided by this Commission, amortization, for purposes of the rules adopted in this proceeding, shall be computed on the straight-line method, i.e., equal amounts shall be recovered in each year of the amortization period. We have applied this approach successfully in common carrier regulation; see 47 C.F.R. §32.2000(h).

[135] We will allow recovery of these costs only to the extent that they are recorded on the company's books as such. The amortization of allowed start-up losses must begin at the end of the prematurity phase of operation, and should generally be completed during the service life of the longest depreciable assets. We believe this will generally be no longer than fifteen years.

[136] For these purposes we conclude that a system reaches maturity as defined by FASB 51 (i.e., presumptively within two years).

[137] We also disallow operating losses incurred on investments that were imprudently made. See part III.A.1., supra.

[138] As stated, cable operators have the opportunity of making a showing to overcome this presumption: such a showing would demonstrate that these costs benefit current and future ratepayers, and that they were prudently invested in plant that is used and useful in the provision of regulated services.

b. Acquisition Costs, Intangibles, and Goodwill

i. Notice

74. In the Notice we observed that cable operators purchasing cable systems in an unregulated environment may have paid a price that exceeded the value of plant under our valuation methodology; we termed this an "excess" acquisition cost.[139] We stated that the legislative history of the Cable Act of 1992 reveals a congressional concern that pre-regulation cable system purchase prices may reflect the undue market power of cable operators not subject to effective competition -- that they are higher, in other words, than they would have been under more competitive market conditions. We tentatively concluded that excess acquisition costs, including portions assigned to goodwill, customer lists, franchise rights, and other intangible assets, should be excluded from the ratebase,[140] and we sought comment on whether such disallowance was Congress' intent.[141] We also sought comment on whether we should allow the amortization

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Operators may also present evidence that allowance is necessary to produce compensatory rates.

[139] Notice at ¶ 36. As we noted there, the expression "excess" acquisition cost compares the cost of acquiring a cable system with the value of the plant, regardless of the valuation methodology selected. It does not necessarily imply that the acquisition cost was "excessive" or imprudent at that time. We noted that excess acquisition costs have traditionally been excluded from the ratebase of regulated entities, at least in part, because they are seen as inappropriate costs for ratepayers to bear.

[140] Id. at ¶ 40.

[141] Id. at ¶ 37. We sought comment on the extent to which cable operators might reasonably assign to the ratebase a portion of their excess acquisition cost as intangible assets, such as customer lists, franchise rights, or goodwill. See also id. ¶¶ 38, 39. We also solicited comment on how such assignments should be determined, and whether we should establish limits on cable operators' discretion to do so. We solicited comment on whether these amounts should be allowed in the ratebase and/or whether the Commission should recognize their amortization as a recoverable operating expense.

of such costs over time as an annual expense.[142] We stated that an equitable balancing of consumer and cable operator interests might require that some excess acquisition costs be allowed in the ratebase, in order to allow for the transition of the industry from a nonregulated to a regulated environment.[143]

ii. Comments

75. Several parties support the exclusion of excess acquisition costs from the ratebase,[144] and state that inclusion of these costs would reflect monopolistic expectations,[145] and

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[142] Id. at ¶ 41 and n.45. We also asked what the amortization period should be for such assets, and for any intangible assets for which we allowed recovery.

[143] Id. at ¶ 39. We also requested comment on: whether there should be some provision for recovery of the return foregone in past years; whether the amount we allow should reflect a reduction for tax benefits received; whether there are specific elements, e.g., the subscriber list, for which provision should be made, but others for which no special provision should be made; and how, if consideration is to be given to previously written-off expenditures for customer lists, franchise rights and other organizational items, they should be valued now. Id. at n.44.

[144] See, e.g., Michigan Comments at 14; Utah Comments at 14; Connecticut Comments at 2; New Jersey Comments at 7; GTE Comments at 21; ETC Comments at 4; Arlington Comments at 1; Seaford Reply at 6; Austin Comments at 8.

[145] For example, CFA argues that the Commission must not allow operators to recover excess acquisition costs which reflect monopolistic abuses. CFA Comments at 3. See also NATOA Comments at 14; NATOA Reply at 6 (a purchasing operator makes a business judgment in determining the price he is willing to pay for a cable system; this decision reflects the operator's analysis of the potential value of the entire cable system and infrastructure, not just regulated services); GTE Comments at 21 (arguing only for exclusion of those costs incurred prior to October 1992); Bell Atlantic Comments at 23; Bell Atlantic Reply at 16 (Congress has determined that excess acquisition costs reflect monopoly profits). Arlington argues that inclusion of excess acquisition costs would produce artificially inflated rates, since subscribers would be forced to help amortize any acquisition price. Arlington Comments at 1.

would harm subscribers.[146] For example, Seaford argues that none of the purchase price of a cable system in excess of the value of plant in service should be allowed recovery as goodwill or intangibles, because that is merely the excess value which an unregulated monopolist can wring from its captive ratepayer.[147] Austin argues against allowance of intangible assets because courts have already decided, based on the industry's own representations, that monopoly cable companies do not have goodwill.[148] Other parties argue that excluding excess acquisition costs from the ratebase is consistent with general principles of utility regulation.[149] Bell Atlantic argues that allowing these costs in the ratebase would provide an

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[146] Bell Atlantic Comments at 24-25; NATOA Reply at 6; see also Bell Atlantic Reply at 17; Austin Reply at 16 (arguing that incorporating monopoly profits into rates for regulated services is contrary to the goals of the Cable Act to protect consumers and to promote competition).

[147] See Seaford Comments at 11. Seaford argues that it is appropriate, however, to allow an operator to assign to goodwill and intangibles the value of the company name.

[148] Austin Comments at 8; Austin Reply at 15, citing Tele-Communications, Inc. v. Commissioner of Internal Revenue, 95 T.C. No. 36 (1990). Austin claims that TCI's experts in that case rejected the existence of goodwill in a monopolistic environment, and asserted that customers return only because they have no choice. Id. at 40. Austin quotes TCI's evidence as stating that a substantial part of the price paid for a system "stems from the prospect it offers to earn supernormal profits ..." Austin Comments at 8, citing "The Value of Three Cable TV Franchises," paper by William B. Shew submitted by TCI in above case.

[149] See Austin Comments at 8; Bell Atlantic Comments, Appendix at 19. Others add that the presumption can be overcome, but that the operator wishing to do so bears a heavy burden. GTE recommends that the Commission create a presumption that excess acquisition costs are monopoly rents, subject to rebuttal by cable operators on an individual basis or by waiver. GTE Reply at 26. Austin notes that the Commission has always insisted that the burden of proof is on the entity seeking to include excess acquisition costs to demonstrate that the price paid for property properly reflects its value to ratepayers or is otherwise in the public interest. Austin Reply at 18.

unjustified competitive advantage for cable over telephone.[150] Austin asserts that excess acquisition costs fail to meet the prudent investment test.[151]

76. Other parties suggest the possibility of a less stringent approach; for example, Aerie suggests that there may be a limited need for special treatment of excess plant or acquisition costs for those unaffiliated small companies that show that, absent the possibility of recovery of these costs, they may face reorganization or insolvency.[152] Michigan and Utah state their belief that exceptions to allowance of excess acquisition costs include reasonable allocations for goodwill, customer lists, and franchise rights.[153]

77. Cable operators argue, however, that calling their acquisition costs "excess" is unfair, and that these costs do not

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[150] Bell Atlantic Comments at 24. See also ETC Comments at 4 (asserting that allowance of these costs may result in a daisy-chain of buy-sell and may produce a disincentive to replace obsolete equipment with more modern equipment).

[151] Austin Reply at 18, 11 (Congress and the FCC have both concluded that discrepancies between replacement and purchase costs, i.e., Tobin's Q, reflect a significant level of monopoly power in the cable industry; even taking criticisms of Tobin's Q into account, evidence shows that the excess acquisition prices paid for cable systems have been based on investor belief that cable was an unregulated monopoly). But see Continental Comments at 33 (the Commission is wrong to assume that acquisition premiums represent uneconomic excesses of the exercise of market power as measured by Tobin's Q). MCATC agrees that these costs should be excluded on a going-forward basis, but states its reservations about the fairness of disallowing acquisition costs incurred by cable operators prior to passage of the Cable Act of 1992. MCATC Comments at 7.

[152] Aerie Comments at 11. Blade argues for an approach that allows for recovery of reasonable acquisition costs without rewarding irresponsible operators who engaged in speculation and acquired systems without equity. Blade Reply at 3-4. Time Warner and TCI argue for a case-by-case approach to the allowance of excess acquisition costs. Time Warner Comments at 31-32; TCI Comments at 19-22.

[153] Michigan Comments at 14; Utah Comments at 14. But see New Jersey Comments at 7 (if excess acquisition costs are allowed in the ratebase as goodwill, these costs should be reviewed on a case-by-case basis).

represent monopoly rents.[154] Operators argue that we should allow full acquisition costs,[155] or at least provide operators an opportunity to overcome a presumptive disallowance.[156] They assert that Congress did not intend exclusion of these costs.[157] Several parties argue that unlike traditional utilities, cable includes a significant investment in intangibles.[158] COA argues

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[154] See, e.g., California Cable Comments at 41-42; Cablevision Industries Comments at 18-21; Eagle Comments at 3; Georgia Cable Comments at 19; Time Warner Comments at 28. These parties assert that disallowance of acquisition costs would deprive the cable operator of the opportunity to earn a reasonable return on its investment. See also Medium Operators Comments at 8 (arguing that exclusion of these costs is appropriate only as such costs are defined as the amounts over the fair market value of a system, including the value of intangibles); California Cable Comments at 41-45 (using the term 'acquisition premium' rather than 'excess acquisition cost').

[155] See, e.g., Eagle Comments at 3.

[156] See, e.g., Cablevision Systems Comments at 25-26, 27-28. See also Continental Comments at 49-51 (in traditional utility regulation the presumption may be overcome by a showing that the transaction was at arm's length and benefited consumers); Arthur Andersen Comments at 31 (this approach is appropriate on a prospective basis); Small Systems Comments at 32-33 (to justify either current rates or a rate increase, the Commission should permit cable operators to include in the ratebase that portion of excess acquisition costs that would generate a return to the cable operator equivalent to any operating expenses that they would have been able to save subscribers through efficiencies related to the acquisition).

[157] See, e.g., NCTA Comments at 17; Small Systems Comments at 24, n.22; Summit Comments at 3; Time Warner Comments at 28; Cablevision Systems Comments at 20-22 (exclusion of excess acquisition costs thwarts Congressional intent because it will deny operators an opportunity to recover all costs, reducing the income-generating potential of these systems). See also Cablevision Industries Comments at 22-23 (exclusion of excess acquisition costs would constitute an unconstitutional taking, because operators were unaware of potential disallowance of these costs); accord, Cablevision Systems Comments at 18.

[158] See, e.g., COA Comments, White Paper Attachment at 25-26; Georgia Cable Comments at 22 (intangibles on a cable system's books were incurred through arm's length transactions in an unregulated environment, have been recorded in accordance with

that a company's intangible resources are often what separates the company from the competition, so these resources must have some future value.[159] COA also asserts that subscribership growth should be included in the ratebase,[160] and that goodwill should be included in the ratebase as a going-concern value.[161]

78. California urges the Commission to take further study to determine the value of the monopoly component of intangible assets, if any, and in the interim to permit a cable system to

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GAAP, and meet the definition of an asset as a future economic benefit over which the entity can exercise control). See also Summit Comments at 4; California Cable Comments at 45 (intangible assets play a vital role in providing cable service, and their total value should be included in the ratebase regardless of the monopoly power of the operator).

[159] COA Comments at 31-36. Specifically, COA argues that the subscriber base at the time of acquisition has value that should be reflected in rates. COA recommends two different methods for estimating value: (1) determining revenue from these customers over the period they remain customers, to project the basic revenue that can be expected from an even base of subscribers, with these revenues discounted over a predefined number of years, yielding an estimate of value of existing subscriber base; and (2) estimating the costs per subscriber associated with building a valid subscriber base. COA urges that franchising operating rights also have value that should be considered in the ratebase. Id. at 36-37. COA recommends an approach for determining this value by considering the situation of an unbuilt start-up system whose only asset is a franchise operating right. A cash flow analysis could be constructed given a range of terminal values for the enterprise at the end of the franchise term and the costs associated with building a cable system from the ground up. The present value difference of these two cash flows would be the value of the franchise operating right.

[160] Id. at 37-40. This could be determined by assessments made at the time of sale by a hypothetical firm.

[161] Id. at 40. See also Comcast Comments at 31-35 (three types of intangibles have typically been identified with cable companies: subscriber lists, franchise value, and going-concern value); Georgia Cable Reply at 8 (Congress, in the Cable Act of 1984, required going concern value to be considered whenever a franchise authority acquires or effects a transfer of a cable system to a third party; this evidences Congressional intent that this amount should be included in the ratebase).

establish the value of these assets, net any monopoly component, using accepted valuation theory.[162] California and Summit argue that these costs should be included in the ratebase and should be eligible for amortization as part of system expenses.[163] TMC argues that at a minimum, and as a transition method, the Commission must allow intangibles to be amortized over the remaining life of the franchise.[164]

79. Other parties argue that the exclusion of excess acquisition costs from the ratebase is unconstitutional.[165] Some urge that a regulatory system that does not allow recovery of acquisition premiums will have a significant adverse impact on

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[162] California Cable Comments at 38, 47, 53-55, 57 (intangible assets of a cable system are those nonphysical resources employed in the operation of the business that alone or in combination are expected to benefit future operations; only three criteria must be met to qualify as an intangible asset: (1) asset must be nonphysical; (2) it must be employed in the operation of the business in question; and (3) it must be expected to earn higher earnings for the business than would be expected without it).

[163] California Cable Comments at 57; Summit Comments at 4.

[164] TMC Comments at 13-14 (if the Commission disallows the value of intangibles from the ratebase and also excludes them as amortization expense, most cable operators will lack sufficient revenue to cover their obligations to lenders, local franchise authorities and the Commission).

[165] See, e.g., Cablevision Systems Comments at 22-26; Georgia Cable Comments at 22 (exclusion raises Fifth and Fourteenth Amendment issues); Small Systems Comments at 25-26; California Comments at 41; Viacom Comments at 26-27 (while it might be constitutional to disallow these costs for regulated entities, this is not the case here); Georgia Cable Comments at 23. See also Comcast Comments at 35-36. Comcast states that allowing these costs into ratebase may lead to higher rates. To remedy this situation, Comcast suggests that the Commission adopt a Z factor that can be added to the price cap increases over the recovery period. This Z factor represents an adjustment for the recovery of an adequate return on an operator's net investment in intangible and tangible assets which would not otherwise be allowed to be recovered under price cap rules.

the industry,[166] its financial structure, its ability to attract capital,[167] and the reasonableness of returns granted to investors in these acquiring companies.[168] Many cable operators point out that competitive firms and regulated industries are routinely purchased at significant multiples of book value, and that this does not necessarily reflect monopoly rents.[169]

80. Further, these parties argue, purchases that occurred prior to regulation do not raise traditional concerns warranting disallowance of excess acquisition costs;[170] the arms-length

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[166] See, e.g., California Cable Comments at 42-43; Cablevision Industries Comments at 22-24 (disallowance of excess acquisition costs will harm subscribers, because they will be denied improvements in the quality and quantity of service they receive); Cablevision Systems Comments at 18; NCTA Comments at 13; TMC Comments at 13.

[167] See, e.g., Eagle Comments at 3; Georgia Cable Comments at 20-21 (operators expected a return on total investment when they invested in systems).

[168] COA Comments at 28. See also Small Cable Reply at 23-25 (exclusion of all intangible assets associated with acquired systems has two flaws: (1) it ignores the reality that an ongoing business has greater value than mere replacement cost of its tangible assets; and (2) many small cable operators have not earned monopoly profits).

[169] See, e.g., COA Comments at 24-26, White Paper Attachment at 15-17, 27-30 and 38-48; Continental Comments at 35-39. NCTA points to the Commission's first rate survey in an attempt to demonstrate that cable rates do not necessarily contain monopoly profits because there was no difference in rates charged by competitive and noncompetitive systems. NCTA Comments at 9 and Attachment. See also Georgia Cable Comments at 22 (for excess acquisition costs incurred prior to regulation, the Commission should at least permit acquisition adjustments such as those that have been allowed when property is transferred between utilities); Summit Comments at 3 (cable operators should be allowed to step up assets to market value, as allowed by the Internal Revenue Service); CATA Comments at 16 (to the extent that acquisition costs are within a system's current market value, they should be recoverable in ratebase).

[170] See, e.g., Viacom Comments at 21-25 (cable operators who purchased systems in arm's length negotiations prior to regulation had no reason to doubt that their purchase price was based upon prevailing market values); Cablevision Industries

purchase price of these systems should be accepted as a fair measure of the value of the system's assets.[171] Some cable operators also assert that systems should be valued at the time the assets were first dedicated to public use, which they contend is when regulation was imposed under the Cable Act of 1992.[172] They assert that if the Commission decides to exclude excess acquisition costs, it should do so only on a going-forward basis.[173]

81. Several cable operators argue for amortization of excess acquisition costs and intangibles as annual expenses, although they propose different amortization periods.[174] Other parties, including some local governments, argue that if excess acquisition costs other than goodwill are included in the ratebase, they should be amortized over a period of at least fifteen years, which will produce the lowest subscriber rates

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Comments at 18-21; Cablevision Systems Comments at 10-11; COA Comments at 46-48; Georgia Cable Comments at 19-20; Medium Operators Comments at 17 and Ernst & Young Study. In fact, many operators argue that the fact that the cable system acquisition price exceeded net book value of plant in service does not necessarily reflect monopoly profits, but may be attributed to the seller's needs to: recapture start-up losses; realize the deferred returns on invested capital; and recover depreciation and interest expenses. See, e.g., Cablevision Systems Comments at 10-11, 19; COA Comments at 27-28; California Cable Comments at 42, 49; Time Warner Comments at 30; Continental Reply at 3.

[171] See Continental Comments at 49-51; Viacom Comments at 21-24.

[172] See, e.g., Viacom Comments at 19.

[173] See, e.g., Cablevision Systems Comments at 27; CATA Comments at 16 and Attachment at 24 (past legal conduct should not be penalized now); Viacom Comments at 24 (at least for this transitional period, the Commission should recognize excess acquisition costs as valid, and allow them in the ratebase).

[174] See, e.g., Medium Operators Comments at 5; Prime Cable Comments at 11 (the "useful life of the cable plant's tangible assets, i.e., 12 years"); Summit Comments at 4 (the fifteen-year period required by tax law); TMC Comments at 14 (the life of the franchise); New York Comments at 6 (as an annual expense amortized over a period of shorter than forty years). The latter argument is discussed in the section on Expenses, infra.

possible.[175] Some parties are opposed to any amortization of excess acquisition costs.[176]

iii. Discussion

1) Introduction

82. In instances where there is a lack of effective competition, as in the period prior to the adoption of the Cable Act, we find that acquisition prices are likely to include amounts paid in expectation of supracompetitive profits, growth premiums for unregulated services, and, quite possibly, simple overpayments. Traditional principles of ratemaking and the policies embodied in the Cable Act also warrant disallowance of costs that do not represent reasonable costs of providing regulated services to customers, equivalent to the costs that would be incurred under competition. This generally includes acquisition costs recorded as goodwill. Disallowance of these costs, contrary to some parties' assertions, is not a penalty but part of the normal and proper balancing of the interests of investors and ratepayers.

83. We also believe, however, that operators are correct in pointing out that some intangible costs do represent costs of providing service that are legitimately included in the operator's ratebase or revenue requirement. This is true whether the operator is an original owner or a purchaser of an established system. We refer to our Part 32 rules, which allow telephone companies to recover intangible costs related to "organizing and incorporating the company, original costs of franchise rights, patent rights, and other intangible property having a life of more than one year."[177] These costs produce assets that provide benefits to subscribers and are thus reasonably recoverable from subscribers. As we discuss below, in some cases, intangible costs may be included in the ratebase; in other cases, they may be treated as an expense, and amortized over a period of years.

84. To balance investors' and ratepayers' interests fairly, we will presumptively allow those types of intangible costs that generally represent reasonable costs of providing service and

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[175] Michigan Comments at 15; Utah Comments at 15.

[176] Bell Atlantic Comments at 25 and Appendix at 19; ETC Comments at 4 (if amortization is allowed, the period should be forty years).

[177] 47 C.F.R. § 32.2690.

that would be incurred under competition. We believe that some intangible costs do generally represent costs used and useful in the provision of regulated services, and thus should properly be recovered in rates. Other intangible costs, including goodwill, will be presumptively excluded.[178] Herein, we discuss which costs should be presumptively included, and which should be presumptively excluded, and the manner in which these costs should be treated in ratemaking.

2) Intangible Costs Presumed To Be Includible In Rates

85. In this section we discuss the specific categories of costs that we conclude should be presumptively includible, and how those costs should be treated in ratemaking.

86. Organizational Costs. Organizational costs typically consist of the cost of organizing and incorporating the company.[179] They will ordinarily have been incurred by the entity originally providing cable service in the franchise area in

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[178] We acknowledge the possibility that disallowance of any excess acquisition costs could have an adverse impact on the cable industry. We believe that the presumption of allowance of certain of these costs, in combination with the fact that an operator can still rebut the presumption of disallowance under set standards, will allow into ratebase the used and useful and prudently invested costs of providing regulated cable service, thus limiting the adverse effect. As we stated in our Docket 19129 Reconsideration Order:

> [R]egulatory bodies have long recognized that acquisition by one utility of the property of another utility presents the possibility for abuse, or at least confuses the question of the proper value to be placed on such property for ratemaking purposes. For this reason, inclusion of such amounts must be determined on a cast-by-case basis and in this connection, it is reasonable to require the acquiring carrier to show how the public who is to be charged a return on investment will benefit from the acquisition and, particularly that the price paid for property accurately reflects its value.

American Telephone and Telegraph Co., 67 F.C.C.2d 1429, 1439 (1978) (Docket 19129 Reconsideration Order).

[179] See 47 C.F.R. § 32.2690. We presumptively disallow from this category stock given to the organizer the value of which is in excess of reasonable salary.